TL-N-10500-

Internal Revenue Service

memorandum

CC:TL:Br2
RPSubin

date: DEC 5 1990

to: District Counsel, [redacted]

from: Assistant Chief Counsel CC:TL
(Tax Litigation)

subject: Request for Tax Litigation Advice
[redacted]

This responds to your tax litigation advice request. As stated in your request, this matter was referred to your office for an advisory opinion by the [redacted] District Examination Division, regarding a claim for refund filed by [redacted] (hereinafter referred to as Fund). Allowance of the Fund's claims would shift the income tax liability to the individual investor banks. The statute of limitations has already expired as to some banks. Forms 872 have been secured from the remaining banks. Therefore, the period of limitations for issuance of a Statutory Notice of Deficiency regarding the banks where forms 872 have already been secured will not expire in the near future.[1]

ISSUES

1. Whether the Fund can be classified as a "regulated investment company" under I.R.C. § 851?

2. Whether the Fund can be classified as a trust, specifically an investor grantor trust?

3. Whether the Fund or the Fund's investment advisor holds the banks' contributions in trust for the benefit of those banks?

4. Whether the Fund can be ignored as being a "passive dummy" corporation?

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[1] On [redacted], [redacted], the attorney who originated the request for tax litigation advice, further requested us to address as many issues as possible raised in [redacted]'s claim for refund. Accordingly, some of these issues have been addressed as sub-issues under the issues requested.

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5. If the taxpayer is correct, whether the government is entitled to relief under either the mitigation provisions of I.R.C. §§ 1311-1314 or the doctrine of equitable recoupment in order to collect the tax from the Fund investors for years which are otherwise closed.

CONCLUSIONS

1. The Fund may not be classified as a regulated investment company under I.R.C. § 851 because:

(a) It was not registered with the SEC under the Investment Company Act of 1940 either as a management company or as a unit investment trust, nor is it a common trust or similar fund excluded by section 3(c)(3) of the Investment Company Act of 1940 from the definition of investment company.

(b) The taxpayer did not make on its tax return a timely election, as required by I.R.C. § 851(b)(1), to be treated for tax purposes as a regulated investment company.

(c) The Fund did not meet the requirement of I.R.C. § 851(b)(3) that less than 30 percent of a regulated investment company's gross income be derived from the sale of investments held for less than three months.

2. The Fund may not be classified as trust, because 1) it was formally incorporated in the state of Maryland, and 2) in any event it would be taxable as an association because it has all the corporate attributes, including having associates and an objective to carry on business.

3. The Fund or the Fund's investment advisor does not hold the banks' contribution in trust for their benefit.

4. The Fund is not a "passive dummy" corporation because it has a business purpose.

5. Depending on the final disposition of the claim for refund and facts that will need to be further developed, the Service may be able to successfully raise the mitigation provisions to collect the tax from the investor banks, notwithstanding the statutory period of limitation under I.R.C. § 6501 for making an assessment of tax. However, because the facts presented fall within the scope of the mitigation provisions, the Service is precluded from raising the doctrine of equitable recoupment.

FACTS

The Fund was incorporated in the State of Maryland on [redacted] to act as a professionally managed open-end, non-registered investment company to invest in short-term and shorter intermediate term fixed income markets. The shareholders of the Fund were [redacted] savings banks with total capital invested of $[redacted].

The Fund was created as a result of legislation effective [redacted], that permitted a [redacted]. The legislation also provided that [redacted]

The Fund was not registered under the Investment Company Act of 1940 at any time during the years at issue, the taxable years ended [redacted] and [redacted]. The Fund filed its corporate income tax returns and paid $[redacted] and $[redacted] for the respective fiscal years. Subsequently, the Fund filed Forms 1120X requesting a full refund of the taxes paid.

The Fund's primary position is that it should be classified as a regulated investment company under I.R.C. § 851. Alternatively, the Fund argues that the Fund itself should be classified as a trust, taxable to the grantors pursuant to I.R.C. § 671, or that the Fund or the Fund's investment advisor merely held the funds contributed by the banks in trust for the benefit of those banks or that it should be ignored as a "passive dummy" corporation. Allowance of the Fund's claims under any theory would shift the income tax liability to the individual investor banks.

LAW SECTION

Section 851(a) of the Code, as in effect for the Fund's tax years ending [redacted] and [redacted], provides that:

> the term 'regulated investment company' means any domestic corporation

> (1) which, at all times during the taxable year, is registered under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 to 80b-2), either as a management company or as a unit investment trust, or
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> (2) which is a common trust fund or similar fund excluded by section 3(c)(3) of such act (15 U.S.C. 80a-3(c)) from the definition of 'investment company' and is not included in the definition of 'common trust fund' by section 584(a).

Section 851(b) provides that:

> a corporation shall not be considered a regulated investment company for any taxable year unless -
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> (1) it files with its return for the taxable year an election to be a regulated investment company or has made such election for a previous taxable year.
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> * * * *
>
> (3) less than 30 percent of its gross income is derived from the sale or other disposition of stock or securities for less than 3 months.

Treas. Reg. § 1.851-2 provides that to be considered a regulated investment company an entity must make an election on its "return for the first taxable year for which the election is applicable" and that "no other method of making such election is permitted."

Section 671 provides that where the grantor is considered the owner of a trust then the income shall be taxed to him.

Section 7701(a)(3) defines a corporation as including an association.

Treas. Reg. § 301.7701-2(a)(1) sets forth six corporate characteristics that are to be taken into consideration in classifying an organization as an association.

> These are: (i) Associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests...

> An organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust...

Treas. Reg. § 301.7701-2(a)(2) provides:

> Since centralization of management, continuity of life, free transferability of interests, and limited liability are generally common to trusts and corporations, the determination of whether a trust which has such characteristics is to be treated for tax purposes as a trust or as an association depends on whether there are associates and an objective to carry on business and divide the gains therefrom.

Treas. Reg. § 301.7701-2(a)(3) provides:

> An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than non-corporate characteristics.

Treas. Reg. § 301.7701-4(c)(1) provides that "an 'investment' trust will not be classified as a trust if there is power under the trust agreement to vary the investment of the certificate holders," but "if there is no power under the trust agreement to vary the investment of the certificate holders, such fixed investment trust shall be classified as a trust."

DISCUSSION

Issue 1 - Qualification as a Regulated Investment Company

In order to be classified as a regulated investment company a corporation must meet the tests specified in I.R.C. § 851.

The fund does not satisfy § 851(a). As the facts reveal, the Fund was not registered under the Investment Company Act of 1940 as a management company or a unit investment trust. Thus, the Fund fails to meet the test required by section 851(a)(1). Furthermore, the Fund does not satisfy the alternative test under section 851(a)(2) because it is not a common trust fund or similar fund excluded by section 3(c)(3) of the Investment Company Act of 1940 from the definition of "investment company." Section 3(c)(3) of that act requires that the common trust fund or similar fund be "maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian." The banks in this instance did not contribute the money to the fund in one of the above-mentioned fiduciary capacities. Thus, the Fund does not qualify under section 851(a)(2), since it is not a fund expressly excluded by section 3(c)(3) of the Investment Company Act of 1940 from the definition of an investment company.

In addition, the Fund does not satisfy section 851(b). The taxpayer did not file an election to be a regulated investment company for tax years ending [redacted] and [redacted]. While the Fund filed an amended corporate income tax return for these years requesting that it be classified as a regulated investment company, the amended return is arguably of no avail.

While there is no authority dealing with the issue of whether an election under section 851 can be made on an amended return,[2] there are a number of cases that define the term "return" in dealing with the validity of other elections being made on an amended return. In J.E. Riley Investment Co. v. Commissioner, 311 U.S. 55 (1940), the Supreme Court held that an election for percentage depletion under then section 114(b)(4) of the Revenue Act of 1934 must be made on an original return. The Supreme Court defined "first return" as used in then section 114(b)(4) as being an original return but not an amended return. Similarly, in Alexander C. Howe v. Commissioner, 44 BTA 894 (1941), the court held "in his return," as used in section 23(c)(2) of the Revenue Act of 1936, meant original return. Likewise, Treas. Reg. § 1.851-2 requires the election to be in the original return since it requires the election to be in the "return for the first taxable year for which the election is applicable." See also, Pacific National Co. v. Welch, 304 U.S. 191 (1938); Keller v. Commissioner, 180 F.2d 707 (10th Cir. 1950); Rev. Rul. 79-277, 1979-2 C.B. 300.

Furthermore, even those courts that don't define what is meant by the term "return" consider the prejudice involved to the government of allowing an election to be made on an amended return. The Seventh Circuit in Clouthier and Merchants National Bank & Trust Company of Indianapolis v. United States, 709 F.2d 480 (7th Cir. 1983), discusses the issue of whether an election under section 1071[3] can be made on an amended return. In

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[2] By use of the term amended return we are referring to an amended return that is not filed within the time that the original tax return is required to be filed. We do not have to consider here the question of the validity of an election made on an amended return filed within the time period that the original tax return is required to be filed.

[3] Section 1071 deals with an election to defer gain in the event a taxpayer is forced to sell property to effectuate policies of the FCC.

Clouthier, the court dismissed cases cited by the taxpayer because those cases did not include situations where the IRS was disadvantaged by allowing an election on an amended return. Furthermore, the ability to make a late election in those cases did not give the taxpayer a benefit of hindsight. The court in Clouthier held that the IRS would be harmed and, thus, no election could be made on an amended return. The court stated that a

> proposed procedure of delayed reporting in an amended return would authorize an undesirable reporting method, which could significantly shorten the period between the time the IRS learned of the transaction and the running of the statute of limitation.

Clouthier at 484. Allowing the Fund to be reclassified as a regulated investment company by filing an amended return will adversely affect the Service. The Service will be barred from collecting the taxes from those banks where the statute of limitations has run and no Form 872 (extensions of the statute of limitations) have been secured. This would be the type of prejudice to the Service contemplated by the Clouthier court. Furthermore, the court in Clouthier acknowledged that "the filing of an amended return is not a matter of right and has, in fact, repeatedly been held to be a matter which is wholly within the discretion of the commissioner." Thus, the Commissioner can properly deny the Fund the opportunity to make an election by an amended return.

The Fund also cites Lucas v. Earl, 281 U.S. 111 (1930), and Commissioner v. Court Holding Co., 324 U.S. 331 (1945), for the proposition that substance should govern over form. Nevertheless, substantively the Fund still fails to meet the requirements of section 851. The Fund had not registered under the Investment Company Act of 1940 and had not filed an election with its return to be a regulated investment company under section 851(b)(1).

Furthermore, according to the examining agent, the Fund also did not meet the requirement of Section 851(b)(3) that less than 30% of a regulated investment company's gross income be derived from the sale or disposition of investments held for less than three months. Thus, it is neither in form nor substance a regulated investment company.

The Fund also argues that the Internal Revenue Code and regulations promulgated thereunder with respect to regulated investment companies should be interpreted so as not to require an investment company otherwise qualifying under such Code provision and regulations as a regulated investment company to be registered with the Security and Exchange Commission (SEC) under the Investment Company Act of 1940 (the 1940 Act) where the 1940 Act and the SEC's regulations promulgated thereunder do not require registration. Section 3(c)(1) of the 1940 Act expressly excludes from the statutory definition of an investment company any investment company whose outstanding securities are held by not more than one hundred persons and which is not making and does not presently propose to make a public offering. The Fund argues that to interpret the Code and the related regulations to require an otherwise qualified investment company, such as the Fund, to be registered with the SEC under the 1940 Act, under circumstances where the 1940 Act and the SEC do not permit such registration, would be an arbitrary, capricious and unreasonable interpretation, wholly unsupported by any congressional purpose or legitimate tax policy.

The Fund's argument is misplaced because Congress permitted the tax-free pass through of income of a regulated investment company, subject only to certain statutory conditions. These conditions include that the fund be subject to strict fiduciary standards and the supervision of the Federal Reserve Board and the SEC.

> The legislative history surrounding the enactment of Code ... § 851 ... clearly evidences a long standing Congressional concern and policy of limiting the tax free pass through of income from mutual investment activities except upon carefully drawn conditions assuring the integrity of the investment activities involved. Thus Congress permitted the tax free pass through of income ... of regulated investment companies only on the condition of such investment activities would be subject to strict fiduciary standards and the supervision of the Federal Reserve Board and the Securities and Exchange Commission.

Common Fund For Nonprofit Organization, G.C.M. 35,390, I-3843 (July 5, 1973) at 18-19. For the foregoing reasons, the Fund can not be classified as a regulated investment company.

Issue 2 - Fixed Investment Grantor Trust

The Fund cites to Revenue Ruling 75-192, 1975-1 C.B. 384 and Revenue Ruling 61-175, 1961-2 C.B. 128, to support a contention that it should be classified as a fixed investment trust as based on its assertion that the Fund's trustee (the investment advisor, hereinafter referred to as Advisor) did not have the power to vary the investment of the Fund's portfolio (the make-up of the investment asset), and that such purported fixed investment trust should be taxed as a grantor trust since the interests in the income from the purported trust have been reserved to the grantor-banks. Hence, each grantor-bank should be treated as the owner of an aliquot portion of the trust, and all income and deductions attributable to that portion should be treated as those of the investor-grantor bank under I.R.C. § 671. By attributing the income and deductions to the investor-grantors (the banks) the Fund will go untaxed. This argument is misplaced for various reasons.

Revenue Ruling 75-192 deals with an investment group having fixed capitalization and formed for the purpose of investing in existing FHA and VA mortgages. Under the agreement, the trustee makes quarterly distributions of all principal and interest payments. During the period between quarterly distribution dates, the trustee is required to invest cash on hand in certain specified instruments. The trustee is permitted to invest only in obligations maturing prior to the next distribution date and is required to hold such obligations until maturity. The trustee has no authority under the trust agreement to purchase new securities or mortgages or to make any other new investments. The ruling concludes that the trustee does not have the power to vary the investment (corpus) and, therefore the entitiy is a fixed investment trust. The ruling then concludes that such trust should be taxed as a grantor trust, because the investor-grantors have interests in the trust's income in proportion to their contributions and therefore, the income from the trust is taxed under sections 671 and 677 to the investor-grantors on their aliquot portions of the trust.

Revenue Ruling 61-175 deals with an investment trust by banks where the trustee has no power to vary the investment of the trust. The ruling concludes that the trustee cannot vary the investment portfolio of the trust. It also concludes that each bank is an owner of their respective portion of the trust under § 671. Accordingly, it also holds that the income, deductions and credits of the trust are to be treated as those of the banks.

Revenue Rulings 75-192 and 61-175 do not apply because as mentioned above the trustee had no power to vary the investment of the portfolio of the trust. "A power to vary the investment of the certificate holders, within the meaning of section 301.7701-4(c) of the regulations, means one whereby the trustee has ... power ... to take advantage of variations in the market to improve the investment of all the beneficiaries." Rev. Rul. 75-192, 1975-1 C.B. 384. Here, the Advisor does have the power to vary the investment portfolio of the Fund. While the Advisor is restricted from purchasing certain kinds of investments, nothing prohibits him from selling the permitted investments before maturity. *See* prospectus at [redacted]. In fact, page [redacted] of the prospectus states that it is the responsibility of the Advisor [redacted] Thus, the Advisor has the power to take advantage of variations in the market to improve the character of the assets in the Fund and therefore the Advisor has a power to vary the investment of the Fund. As a result, the Fund will not qualify as a fixed investment trust under Treas. Reg. § 301.7701-4(c). See Commissioner v. North American Bond Trust, 122 F.2d 545, 546 (2d Cir. 1941), cert. denied, 314 U.S. 701 (1942) (cited in the above regulation). Since the Advisor of the Fund can vary the investment of the Fund these revenue rulings do not apply.

In any event, a determination under the criteria of Treas. Reg. § 301.7701-2 of whether an entity is either an association, taxable as a corporation, or a trust is only necessary when there is no formal incorporation under state law. The Fund, having an opportunity to choose the entity in which to operate, chose the corporate form. It incorporated under state law and is thus a corporation, per se, and therefore not a trust. Furthermore, once a taxpayer chooses an entity form, he cannot then attack it. See, Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943). In National Alfalfa v. Commissioner, 417 U.S. 134, 139 (1973), the Supreme Court stated "this court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the consequences of his choice." Thus, the Fund may not now argue that it is entitled not to be taxed as a corporation.[4]

Furthermore, even if the formal incorporation of the Fund were ignored, the Fund should be classified as an association taxable as a corporation because by testing the six corporate characteristics of Treas. Reg. § 301.7701-2(a)(1) to the characteristics present in the Fund, more corporate characteristics exist than non-corporate characteristics. As Treas. Reg. § 301.7701-2 states the only two relevant tests in distinguishing a trust from an association are whether there are associates and whether there is an objective to carry on business and divide the gain therefrom. "If the beneficiaries supplied the corpus of the trust, they ordinarily are treated as associates." 10 Mertens, Law of Federal Income Taxation, § 38A.25, at 66 (Rev. 1988). Therefore, since the banks contributed the money to the Fund by purchasing units they are the associates. "The primary source for determining the business objective of a trust is the trust instrument." 10 Mertens, § 38A.24, at 64. Thus, in this instance, the prospectus would function as the trust instrument. The purpose of the fund is not merely to hold and conserve property but, [redacted] See prospectus at [redacted] and [redacted]. Thus, the Fund has associates and an objective to carry on business and divide the

[4] See also discussion in Issue 4 relating to "passive dummy" corporations.

gains. Therefore, the Fund cannot be classified as a trust.

Furthermore, the Fund has all of the other elements required by Treas. Reg. § 301.7701-2(a)(1) to be an association taxable as a corporation.

1. Continuity of Life: The Fund will not dissolve by the death, insanity, bankruptcy, retirement, resignation, or expulsion of any of the banks who are members of the Fund. The Fund appears to continue as originated even where shares of a member bank are redeemed. See prospectus at [redacted] and [redacted]. Thus, the corporation has continuity of life. See Treas. Reg. § 301.7701-2(b).

2. Centralization of Management: The Fund has directors and officers. See prospectus at [redacted]. Furthermore, the Advisor is responsible to make investment decisions. See prospectus at [redacted]. Therefore, the Fund has centralized management because there is a concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization. Treas. Reg. § 301.7701-2(c)(3).

3. Limited Liability: Under local law there is no member bank of the Fund who is personally liable for the debts or claims against the Fund. Thus, there is limited liability. See Treas. Reg. § 301.7701-2(d)

4. Free transferability of Interests: An organization has the corporate characteristic of free transferability of interest if each of its members have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization. See Treas. Reg. § 301.7701-2(e)(1). The Fund's units may not be transferred or resold. However, they may be redeemed. This characteristic may be considered a modified form of free transferability. While a modified form is accorded less weight it still may be a consideration.

Nevertheless, even if there is no free transferability of interests the Fund still has more corporate than non-corporate characteristics and thus is an association taxable as a corporation.

Issue 3 - Fund or Advisor Holding Banks' Contributions in Trust For Their Benefit.

The Fund also cites Florists Transworld Delivery Association v. Commissioner, 67 T.C. 333 (1976), gov't appeal dismissed (nolle Pros.), (6th Cir. 1978), acq. 1978-2 C.B. 2, non acq.

(regarding this issue) 1978-2 C.B. 3; Seven Up v. Commissioner, 14 T.C. 965 (1950), acq. in result, 1974-2 C.B. 4; and Revenue Ruling 74-319, 1974-2 C.B. 15, for the proposition that "to the extent the shareholders' funds paid directly to the Advisor were deemed to have been received by the Fund such funds were held only in trust for the benefit of shareholders and no gross income would be realized therefrom by the Fund," therefore, "the Fund was ... a conduit for pooling funds received by the Advisor only for the purpose of collective investment by the Advisor as intended by the shareholders." See Fund's Claim For Refund. Thus, no gross income would be realized by the Fund. This argument looks to whether the Fund held the investment portfolio at issue in trust for others, i.e., as trustee, or in its own right. For this argument the entity status of the Fund itself is not pertinent. Nevertheless, Florists Transworld Delivery Association, Seven Up and Revenue Ruling 74-319 are distinguishable.

In Florists Transworld Delivery Association, Florists Transworld Delivery (FTD) was organized as a nonprofit corporation and a membership organization composed of retail florists. FTD received advances from its members which it was obligated to apply to the cost of clearing their intercity exchanges of flower orders. Petitioner also received advances from members which it was obligated to use for national advertising. The court concluded that the clearing house and marketing advances did not constitute gross income to FTD. The court held that these advances were held in trust, because FTD was obligated to expend the advances for a specific purpose.

Revenue Ruling 74-319 deals with a situation where a manufacturer received money from its distributors for a national advertising plan. The money received from the dealers is commingled with the manufacturer's own receipts from its business. The manufacturer then spends this money on national advertising for the benefit of all dealers. These facts are similar to those considered in the Seven Up case. The ruling concludes that the money received from the dealers by the manufacturer is not included in the gross income of the manufacturer nor is the money spent by the manufacturer on advertising considered a deduction by the manufacturer because the manufacture was burdened with the obligation to use the money for national advertising.

Therefore, in all three of the situations the funds had to be expended for a specific purpose. Here the funds to be invested are funds that do not need to be expended for a specific purpose. The Fund has power to exercise day-to-day business judgments over the funds. The Fund determines which securities, subject only to certain limitations, to invest in and when to sell these securities. Thus, the Fund is not acting as an agent, trust or trustee, since it has the attributes of an independent contractor. See Florists Transworld Delivery Association, AOD-OM 70,255 (May 26, 1978). In fact, the Fund was created for production of [redacted] See prospectus at [redacted] and [redacted].

Revenue Ruling 74-319 also states that the dealers themselves are considered to be an association taxable as a corporation and required to file a corporate income tax return, Form 1120. The ruling goes on to revoke the acquiescence in Seven Up and substitute an acquiescence in result only. The Fund appears to be claiming that their position is that of the manufacturer, which the revenue ruling says is not taxable because it is merely holding the funds in trust for an association[5] of banks and therefore, the wrong entity is being taxed. That is, the banks by pooling their money are an association and thus the proper taxable entity. Thus, the Fund merely holds the funds in trust for this association. This argument will fail because the Fund clearly received the money in its own right. The Fund received the funds from the banks by the banks purchasing shares in the Fund. The Fund's prospectus clearly envisions that such corporation will invest and reinvest in its own right and not on behalf of others. Therefore, since contributions to the Fund are by purchase they cannot be a trustee. In fact, the Fund is more analogous to the dealers pooling their money in an entity and thus the Fund is the Association and thus taxable as a corporation. See also Rev. Rul. 74-318, 1974-2 C.B. 14.

Even if the rationale of Florists Transworld Delivery Association and Seven Up apply the Service does not acquiesce in their rationales relating to this issue.

The trust theory also fails because as the prospectus states on page [redacted], pursuant to [redacted] Thus, to qualify under the [redacted] statute, a corporation must be the entity engaged in the investing and reinvesting activities; so the entity may not be a trust. Similarly, for this reason the Fund's reliance on Prairie Center Oil Development Company v. Commissioner, T.C. Memo. 1958-177, is also incorrect since that case deals with a corporation formed "to provide a means for distributing ... proceeds," rather than engaging in a business. In fact, the corporation's articles of incorporation specifically stated "that the corporation is not to engage in any business or profit to itself." Here, however,

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5 This argument of the Fund holding the money in trust, i.e. as trustee, for the banks is similar to the Fund acting merely as an agent of the banks. See footnote 7.

the Fund's objective is to create income. See, prospectus at [redacted] and [redacted]. Therefore, the Fund cannot be classified as a trust.

Issue 4 - Ignored as Passive Dummy Corporation

In order for a corporation to be ignored as a "passive dummy" corporation, a corporation must serve no business purpose and thus be a sham. See Moline Properties, Inc. supra; Paymer v. Commissioner, 150 F.2d 334 (2nd Cir. 1945). Furthermore, "the Commissioner, to prevent unfair tax avoidance, has greater freedom and responsibility to disregard the corporate entity than a taxpayer, who normally cannot be heard to complain that a corporation which he has created, and which has served his purpose well, is a sham." Commissioner v. State-Adams Corporation, 283 F.2d 395, 398-399 (2nd Cir. 1960), cert. denied, 365 U.S. 844 (1961); see Federal National Mortgage Association v. Commissioner, 90 T.C. 405, 426 (1988); Bolger v. Commissioner, 59 T.C. 760, 767 4 (1973), acq. 1976-1 C.B. 1. Thus, any argument on behalf of the taxpayer that his corporation is a passive dummy must overcome this strict obstacle.[6]

The Fund actively trades in short term securities during the taxable years and the Fund decides which securities to invest in. Furthermore, the Fund has the power to exercise day-to-day business judgment and performs significant business activities. Thus, it is not a passive dummy. See Moline Properties, Inc.; Commissioner v. Jesse C. Bollinger, 108 S. Ct. 1173 (1987).[7]

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[6] See also discussion of trusts in Issue 2 and 3.

[7] Any argument by the Fund that the corporation merely exists as an agent of the banks will also fail because the Fund does not satisfy the tests set forth in National Carbide, 336 U.S. 442 (1948). In National Carbide, the Court found the following six factors helpful in determining whether an agency relationship exists:

1. whether the corporation operates in the name and for the account of the principal;
2. whether the corporation binds the principal by its actions,
3. whether the corporation transmits money received by the principal;
4. whether income is attributable to the services of employees of the principal and to assets belonging to the principal.
5. if relations with the principal are dependent on the fact that it is owned by the principal, a true agency does not exist; and
6. its business purpose must be carrying on of the normal duties of an agent.

The prospectus reveals that they do not meet these agency tests.

Furthermore, it is clear that the Fund does have a business purpose. The Fund must be a corporation pursuant to [redacted] to have the advantage of investing. This advantage constitutes a business purpose because "whether the purpose be to gain an advantage under the law of the state of incorporation[8] ... So long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." Moline Properties, Inc. at 438-439; see Bolger at 767.

Issue 5 - Mitigation or Equitable Recoupment

The mitigation provisions are a statutory response to the judicially created equitable doctrines of recoupment, setoff and estoppel. While they attempt to correct the same inequitable results, the equitable doctrines often produce uncertain results. Accordingly, Congress believed legislation was required to clear the murky waters. The mitigation provision, as originally enacted (1939 I.R.C. § 3801), was based on four principles:

> (1) To preserve unimpaired the essential function of the statute of limitations, corrective adjustments should (a) never modify the application of the statute except when the party or parties in whose favor it applies shall have justified such modification by active inconsistency[9] and (b) under no circumstances affect the tax save with respect to the influences of the particular items involved in the adjustment.
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> (2) Subject to the foregoing principles, disputes as to the year in which income or deductions belong, or as to the person who should have the tax burden of income or the tax benefit of deductions, should never result in a double tax or a double reduction of tax or in an inequitable avoidance of tax.
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> (3) Disputes about the basis of property should not allow the taxpayer or the Commissioner to obtain an unfair tax advantage by taking one position at the time

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[8] The rationale of this statement is still applicable even though the benefit is being derived in [redacted] and the corporation is incorporated in Maryland. The corporation is still, nonetheless, gaining an advantage under a state law and performing a business purpose.

[9] This active inconsistency requirement is not followed by all courts. See Yagoda v. Commissioner, 331 F.2d 485 (2d Cir. 1964), cert. denied, 379 U.S. 842 (1964); Chertkof v. Commissioner, 66 T.C. 496 (1976); Priest v. Commissioner, 6 T.C. 221 (1946).

of the acquisition of property and an inconsistent position at the time of its disposition.

(4) Corrective adjustments should produce the effect of attributing income or deductions to the right year and the right taxpayer and of establishing the proper basis.

S. Rep. No. 1567, 75th Cong., 3d Sess. 48 (1938), reprinted in 1939-1 (Part 2) C.B. 779, 865.

Thus, unlike the equitable doctrines, mitigation actually opens the closed year to correct the erroneous treatment.

The party raising the argument has the burden of proving the appropriateness of applying the mitigation provisions. Olin Mathieson Chemical Corp. v. United States, 265 F.2d 293, 296 (7th Cir. 1959); Chertkof v. United States, 676 F.2d 984, 990 (4th Cir. 1982). To be entitled to relief, the party must show the following:

(1) A determination (as specifically defined in Section 1313) must establish that the treatment in another year was incorrect.

(2) Correction of the error in the other year must be barred by some rule of law, usually the period of limitations on assessment or refund.

(3) The party successful in the determination must have asserted a position inconsistent with a position adopted in the barred year. There are only two exceptions to this inconsistency requirements.

(4) The determination must result in one of the seven circumstances specifically described in Section 1312, i.e., the double exclusion of an item of income or the double allowance of a deduction.

I.R.C. § 1311.

The determination can be any one of the following:

(1) A decision by the Tax Court or a judgment, decree, or other order by any court of competent jurisdiction that has become final;

(2) A closing agreement made under Section 7121;

(3) A final disposition by the Internal Revenue Service of a claim for refund; or

(4) An agreement between the taxpayer and the Service authorized by Section 1313(a)(4).

I.R.C. § 1313.

The court's determination is merely the triggering event under mitigation. Before an adjustment may be made, the losing party must file the appropriate document (claim for refund or notice of deficiency). Benenson v. United States, 385 F.2d 26 (2d Cir. 1967); J.B.N. Telephone Co., Inc. v. United States, 638 F.2d 227 (10th Cir. 1981); 2 J. Mertens, The Law of Federal Income Taxation § 14.11, at 57 (1976).

To successfully invoke the mitigation provisions, the determination must result in one of the following "seven circumstances":

1. Double inclusion of income;
2. Double allowance of deduction or credit;
3. Double exclusion of income;
4. Double disallowance of deduction or credit;
5. Correlative deduction or inclusion regarding trusts and estates and their beneficiaries;
6. Correlative deductions and credits for related corporations;
7. Basis of property after erroneous treatment of a previous transaction.

I.R.C. § 1312.

Section 1313(c) of the Internal Revenue Code provides that to invoke the mitigation provisions, the taxpayer involved in the determination must be the same taxpayer or related to the taxpayer raising mitigation in one of the following ways:

1. husband and wife,
2. grantor and fiduciary,
3. grantor and beneficiary,
4. fiduciary and beneficiary, legatee or heir,
5. decedent and decedent's estate,
6. partner, or
7. member of an affiliated group of corporations as defined in section 1504.

If the Fund is found to be a regualted investment company or "passive dummy" corporation, it appears from the facts presented that the Service will be able to meet some but not all of the requirements necessary to successfully raise the mitigation provisions and collect the tax from the investor banks.

The allowance of the Fund's claim for refund is a final disposition of the claim and thus, under I.R.C. § 1313, is a "determination" as required by I.R.C. § 1311. The correction of the error, double exclusion of income, would be barred with respect to the investor banks from which no Form 872 was secured. Moreover, the investor banks asserted a position in the barred years which is inconsistent with the determination that they should pay the income tax liability. However, under the definition of related party, the Fund and the investor banks do not meet the definition of related parties. I.R.C. § 1313(c). Accordingly, the Service would be unable to successfully collect the tax from the investor banks through the use of the mitigation provisions. It should be noted that the Tax Court has specifically held that a principal and his agent are not related taxpayers. Taylor v. Commissioner, 27 T.C. 361 (1956), aff'd, 258 F.2d 89 (2d Cir. 1958).

If the Fund is found to be a trust the Service may be able to raise the mitigation provisions depending on certain facts not provided as well as [redacted] law. As noted above, the Service meets all of the tests except the related taxpayer test. If the Fund is treated as a trust, it is possible that the investor banks would be related taxpayers under I.R.C. § 1313(c)(3), grantor and beneficiary. Under the grantor trust rules the grantors and the beneficiaries are treated as the same person for federal tax purposes. However, reliance solely on this fiction to support our ability to raise the mitigation provisions is not recommended. Courts have held that the tax treatment of one "related party" does not change the nature of the relationship between the fiduciary and the beneficiary. Lovering v. U.S., 49 F.Supp, 1 (D. Mass. 1943); I.T. 3986, 1949-2 C.B. 109; Taylor v. Commissioner, 27 T.C. 361 (1956). Accordingly, the determination as to whether the Fund should be considered a grantor and whether the investor banks should be considered beneficiaries should be treated as if controlled by [redacted] law. If the Fund is found to be a trust, this issue will need to be further explored.

If, under [redacted] law the Fund and the investor banks are deemed related parties for purposes of I.R.C. § 1313(c)(3), there is still a timing issue to be considered. The parties must have been related both at some time during the year in which the erroneous treatment occurred and also when the inconsistent position is first maintained. I.R.C. § 1311(b)(3). This would be during the years at issue and at the time income tax returns were filed by both the Fund and each investor bank. The facts do not specify if the relationship between the Fund and the investor banks existed after the end of fiscal year [redacted] or when the returns were filed with respect to the individual parties. The fact that the Fund filed returns for fiscal years [redacted] and [redacted] leaves one to speculate that the Fund may have been discontinued after the close of the [redacted] fiscal year. If the Fund is found to be a trust, these facts will need to be further developed.

The memorandum from the revenue agent attached to the TLA request raises the possibility of relief under the doctrine of equitable recoupment. Recoupment allows a party to defeat a claim against it by making a demand arising from the same transaction. It differs from mitigation in several respects. In mitigation the statute operates to open a closed year and make the proper adjustment. Recoupment, however, merely permits an offset in the open year before the court. It cannot serve as an independent basis to open a closed year. Moreover, while mitigation does have an ultimate statutory deadline, recoupment is never barred by statute. United States v. Dalm, 110 S. Ct. 1361 (1990); Bull v. United States, 295 U.S. 247 (1935).

In order to claim recovery under recoupment, there must be a close relation between the item in issue in the open year and the item causing the inequitable treatment in the closed year. This is often referred to as the single-transaction or single-taxable-item element. Bull, 295 U.S. at 261; Rothensies v. Electric Storage Battery Co., 329 U.S. 296 (1946). Thus, "the offsetting amount from the year barred by the statute of limitations must result from the transaction which gave rise to the refund or deficiency in the open year." 10 J. Mertens, The Law of Federal Income Taxation § 60.05, at 16 (1976). The Supreme Court noted in Dalm "a party litigating a tax claim in a timely proceeding may, in that proceeding, seek recoupment of a related, and inconsistent, but now time-barred tax claim relating to the same transaction." 110 S. Ct. at 1368.

Recoupment may be raised by or against the same taxpayer maintaining the action in the open year or to a taxpayer closely related. Stone v. White, 301 U.S. 532 (1937) (Testamentary trust trustee and trust beneficiaries deemed related persons); Estate of Vitt v. United States, 706 F.2d 871 (8th Cir. 1983) ("the same parties detrimentally affected by the overpayment will receive the proceeds from recoupment; no additional parties will benefit from recoupment here, nor will any party previously affected adversely be precluded from recovery." at 875 n. 3). The equitable result sought by recoupment is to place the parties in their proper positions assuming no statutory bar to the actions. Neither the taxpayer nor the Commissioner ought to possess more tax than it should have respectively paid or received. Stone, 301 U.S. at 539.

While it appears that the Service meets the requirements necessary to raise equitable recoupment, it is unlikely we would be successful. As noted above, Congress enacted the mitigation provisions to provide a measure of uniformity and predictability into situations such as the one presented here. The result sought by Congress implies that some measure of exclusivity ought to be afforded to the mitigation provision. Moreover, Congress regarded the mitigation provisions as supplementing the equitable doctrines previously applied. "Recoupment, then, would not be available if a court should find that the situation in question falls within the general scope of the statutory provisions but does not meet each requirement of the statute." Benenson v. United States, 385 F.2d 26, 32 (2d Cir. 1967), citing, Gooding v. United States, 326 F.2d 988 (Ct. Cl. 1964), cert. denied, 379 U.S. 834 (1964). Accordingly, we do not recommend raising the doctrine of equitable recoupment.

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